CHAPTER 14

REVISE TREATMENT OF RETIREMENT SAVINGS

Current law provides tax-favored treatment to funds set aside in any of several employer-sponsored or individual plans providing for deferred compensation or retirement savings. Such "tax-favored plans" include qualified profit-sharing, stock bonus, and pension plans (section 401(a)); qualified annuity plans (section 403(a)); certain annuity contracts, custodial accounts, and retirement income accounts (tax-sheltered annuities) (section 403(b)); individual retirement accounts and annuities (IRAs) (section 408(a)&(b)); and simplified employee pensions (SEPs) (section 408(k)).

The Administration proposals generally would maintain the current treatment of tax-favored plans. The proposals, however, would simplify existing rules and provide more uniform treatment of the various plans. In addition, the proposals would target the favorable tax treatment more directly at reasonable accumulations of retirement savings by applying excise taxes designed to recapture unintended tax advantages where plan benefits are diverted from retirement savings or are in excess of reasonable levels.

Uniform rules, including an excise tax on early distributions, would govern distributions from the various types of plans, and more uniform contribution limits would be established. The overall limit on non-top-heavy defined benefit and defined contribution plans would be eliminated, and an excise tax would be imposed on annual distributions from tax-favored plans in excess of specified limits. The current rules governing IRA contributions by married couples would be made more equitable. Cash or deferred arrangements would be made more comparable to IRAs by the application of a special annual dollar limit. In addition, the related nondiscrimination rules for elective contributions and employer matching contributions under these and similar elective arrangements would be modified to assure that broad cross-sections of employees actually benefit. A special nondiscriminatory coverage rule also would be applied to employer-maintained plans to assure that such plans achieve the same fundamental goal.

Certain adjustments would be made to the current rules governing the tax treatment of loans to participants from qualified plans to assure that tax-favored funds are not available for permanent use before retirement. An excise tax would be applied to qualified plan funds reverting to an employer upon plan termination. Qualified pension plans would be permitted to use benefits forfeited by separated employees to increase the benefits of other employees. Finally, the existing limits on unfunded deferred compensation for employees of States, with certain modifications, would be extended to unfunded deferred compensation arrangements for employees of tax-exempt employers.

INCREASE SPOUSAL INDIVIDUAL RETIREMENT ACCOUNT LIMIT

General Explanation

Chapter 14.01

Current Law

An individual generally is permitted to deduct annual contributions to an individual retirement account or annuity (IRA) up to the lesser of $2,000 or 100 percent of the individual's annual compensation. Thus, if a married individual and his or her spouse each receive compensation during a year, each may make separate deductible contributions to his or her own IRA up to the lesser of $2,000 or 100 percent of compensation.

If an individual receives no compensation during a year, the individual generally is not allowed to make a deductible IRA contribution for such year. Special "spousal IRA" limits, however, provide that if a married individual's spouse earns no compensation during a year for which the married couple files a joint return, the individual may deduct annual IRA contributions up to the lesser of $2,250 or 100 percent of the individual's annual compensation. The contributions may be allocated in any fashion between the individual's IRA and the nonearning spouse's IRA, except that no more than $2,000 may be contributed to either IRA.

The special spousal IRA maximum limit of $2,250 is not available if the married individual's spouse has compensation income during the year. Thus, if a husband and wife each has compensation income, each is separately subject to the $2,000 and 100 percent of compensation limits on deductible contributions. As a consequence of this rule, a married couple with a nonearning spouse is permitted to make larger total deductible IRA contributions than a married couple with a spouse who has compensation income of less than $250.

Reasons for Change

The tax benefits applicable to IRAs are intended to encourage individuals to save for retirement. Savings for this purpose also contribute to the formation of investment capital needed for economic growth. For many individuals, including individuals who are covered by employer-maintained retirement plans, IRAs may play an important part in an overall strategy to provide for retirement security. The use of IRAs for retirement saving should thus not only be encouraged, but made available on a broad and consistent basis.

The existing limitations on IRA contributions are illogical and inequitable as applied to married couples. The relatively minor allowances for a spousal IRA fail to recognize the important economic contributions made by nonearning spouses. Moreover, they are inconsistent with other rules of current law under which married couples are treated as an economic and taxpaying unit. Thus, a husband and wife that each earn \$10,000 can make aggregate IRA contributions of \$4,000 under current law. A couple with the same joint income of \$20,000, all of it earned by one spouse, may make aggregate IRA contributions of only \$2,250. A third couple, also with \$20,000 of joint income, but with one spouse earning only \$200, is limited even further to a \$2,200 aggregate IRA contribution. These disparate results are inconsistent with both retirement savings policy and general tax principles requiring similar treatment of similarly situated taxpayers.

Proposal

A married individual filing a joint return, including an individual with no annual compensation, would be permitted to take into account his or her spouse's compensation (less the deductible IRA contribution made by such spouse) in determining the deduction limit for such individual. Thus, married couples with aggregate compensation of \$4,000 or more ultimately would be entitled to a \$4,000 aggregate IRA contribution (\$2,000 apiece) regardless of how much of the aggregate compensation was generated by either spouse.

Deductible IRA contributions would be coordinated with the dollar limit on elective contributions under a cash or deferred arrangement. See Ch. 14.06.

Consideration would be given to the adoption of rules preventing in appropriate instances the deduction of interest attributable to indebtedness incurred to make deductible IRA contributions. If adopted, such rules would conform to current law principles barring the deduction of interest on indebtedness incurred or carried to generate tax-exempt income.

Effective Date

The spousal compensation rule for married individuals would apply to taxable years beginning on or after January 1, 1986.

Analysis

The proposed spousal compensation rule would permit certain married couples to set aside additional amounts in IRAs for long-term savings. This would enhance retirement security for such couples, and should also contribute to increased capital formation and productivity.

UNIFY RULES FOR DISTRIBUTIONS FROM TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.02

Current Law

Current law provides tax-favored treatment with respect to a variety of employer-sponsored and individual plans. Although these tax-favored plans are related in concept and purpose, distributions from the plans are subject to differing requirements and may result in significantly different tax consequences to individual recipients.

Minimum Distribution Requirements. Tax-favored retirement plans are subject to certain minimum requirements concerning the timing and amount of distributions. Qualified profit-sharing, stock bonus, pension, and annuity plans must generally commence distributions no later than the April 1 following the year in which the employee attains age 70-1/2 or, if later, the year in which the employee retires. (Distributions to five percent owners must commence no later than the April 1 following the year in which the individual attains age 70-1/2.) Benefits thereafter must be distributed under a minimum distribution schedule. Additional rules require minimum annual distributions where the employee dies before benefit distributions have commenced or have been completed. A qualified plan failing to satisfy the minimum distribution rules with respect to a participant may lose its tax-favored status.

Individual retirement accounts (IRAs) and simplified employee pensions (SEPs) must commence distributions no later than the April 1 following the year in which the IRA or SEP owner attains age 70-1/2, without regard to whether such owner has retired. Thereafter, benefits must be distributed under lifetime and after-death distribution schedules similar to those for qualified plans. An IRA or SEP that fails to satisfy the minimum distribution rules does not lose its tax-favored status. Instead, the payee is subject to an excise tax of 50 percent of the amount by which the required distribution exceeds the amount actually distributed.

Benefits provided through tax-sheltered annuities are not subject to minimum distribution rules for the period during which the original holder of the annuity remains alive. If, however, the holder dies before the entire interest in the annuity is distributed, distribution rules based on the after-death rules for qualified plans must be satisfied. (A technical correction bill has been introduced in Congress that would subject tax-sheltered annuities to lifetime and after-death distribution rules similar to those for qualified plans.)

Tax Treatment of Distributions. In general, amounts distributed from tax-favored plans are fully taxable to the recipient at the time of distribution. There are a variety of exceptions to this general rule under which certain distributions incur additional taxes and certain others receive more favorable tax treatment than ordinary distributions.

Early Distributions. Distributions from an IRA or SEP before the IRA or SEP owner dies, becomes disabled, or attains age 59-1/2 generally are subject to a ten percent additional tax. Similar distributions from a qualified profit-sharing, stock bonus, pension, or annuity plan are subject to an additional tax only in the case of employees owning more than five percent of the employer. Early distributions from tax-sheltered annuities are not subject to an additional tax. However, distributions from tax-sheltered custodial accounts are generally prohibited absent financial hardship, separation from service, the attainment of age 59-1/2, death, or disability.

Lump Sum Distributions. Preferential tax treatment is currently available for certain lump sum distributions from qualified profit-sharing, stock bonus, pension, and annuity plans. Under a special forward averaging rule, the tax liability on a lump sum distribution is generally determined as though the individual received the distribution ratably over ten years and as though the individual received no other taxable income during such period. In addition, the portion of a lump sum distribution attributable to plan participation before 1974 may be taxed at capital gain rather than ordinary income rates. Whether a lump sum distribution qualifies for favorable treatment is determined under an extensive set of rules, based in part on the employee's age, employment status and years of participation in the plan. Favorable lump sum treatment is not available for distributions from IRAs, SEPs, or tax-sheltered annuities.

Employer Securities. Current law also provides preferential tax treatment for unrealized appreciation on employer securities included in a lump sum distribution from a qualified profit-sharing, stock bonus, or pension plan. Such appreciation is not included in income at the time of distribution, but instead is taxable upon subsequent disposition of the securities, ordinarily at capital gain rates. If the distribution is not a lump sum distribution, only the unrealized appreciation on employer securities purchased with employee contributions qualifies for the special treatment. Unrealized appreciation on plan distributions of securities other than employer securities is fully taxable upon distribution.

Basis Recovery. Tax-favored plans are subject to special rules for the recovery of employee contributions previously subject to tax. Outside the area of tax-favored plans, an amount not received as an annuity before the annuity starting date is generally treated, first, as a taxable distribution and, second, as a tax-free recovery of employee contributions. This basis recovery rule is reversed, however, for a non-annuity distribution from a qualified profit-sharing, stock bonus, pension, or annuity plan or a tax-sheltered annuity, so that such distribution is treated, first, as a tax-free recovery of employee contributions.

Tax-favored plans are also granted special treatment for amounts received as annuities after the annuity starting date. Under the general basis recovery rules, employee contributions are recovered tax-free on a pro rata basis, in accordance with an exclusion ratio based on the employee's life expectancy at the time distributions commence. An employee's after-tax investment in a tax-favored plan, however, is recovered prior to any taxable distributions, provided that the aggregate amount to be distributed during the first three years exceeds such after-tax investment.

Rollovers. Distributions from a tax-favored plan (including distributions of property, such as employer securities) are not subject to taxation to the extent rolled over to another tax-favored plan. Generally, a plan distribution may be rolled over to another plan if it qualifies as a lump sum distribution, and may be rolled over to an IRA if it is at least 50 percent of the employee's total benefit in the plan. A complex series of rules governs the extent to which distributions from particular plans may be rolled over as well as the type of plans to which rollovers may be made. In general, these rules are designed to prevent individuals from avoiding restrictions applicable to certain plans by shifting benefits to a plan that is free of the restrictions.

Constructive Receipt. In general, benefits under tax-favored plans are taxable when received. For most plans, receipt occurs for tax purposes only when benefits are actually distributed. The doctrine of constructive receipt is applied, however, to benefits under tax-sheltered annuities, which may be treated as received either when actually distributed or when made available to the individual. As a consequence, benefits in such annuities may be taxable prior to their actual distribution.

Reasons for Change

The current rules for distributions from tax-favored plans are burdensomely complex for taxpayers and inconsistent in their treatment of similarly situated individuals. The current rules also undercut the basic rationale for tax-favored plans, which is the encouragement of retirement savings, and in certain instances provide excessively favorable treatment.

Uniform Treatment of Distributions. The various tax-favored plans are important components of a general policy to enhance individual retirement income security. The current absence of uniformity in the treatment of such plans creates significant disparities among individuals based on the type of plans to which the individuals happen to have access. Uniform rules would eliminate such disparities and also reduce the complexity of the existing rules governing plan distributions. Existing differences in the tax treatment of plan distributions give tax considerations undue influence over an individual's choice of retirement plans. Moreover, they require individuals either to master a complex set of rules or to seek professional advice. In too many cases they may result in a loss of possible benefits. Uniform rules would have the additional advantage of making unnecessary most of the current restrictions on the shifting of benefits from one plan to another.

The tax-favored status of retirement plans is intended to enable individuals to replace, after retirement, compensation that terminates with retirement. Minimum distribution rules support this rationale by limiting the extent to which tax-deferral on retirement savings can be extended beyond the individual's retirement. Given the purpose of minimum distribution rules, they should apply to all retirement plans receiving tax-favored treatment.

Uniform sanctions should also apply to violations of minimum distribution rules. The sanction of disqualification, however, is too onerous for a plan's failure to satisfy the highly technical requirements. Disqualification may result in adverse tax consequences to all plan participants, even though plan administration generally is outside the control of the participants and the failure may have occurred with respect to only a single participant. Plan disqualification procedures also impose a significant administrative burden on the Internal Revenue Service.

Encourage Retirement Savings. The current favorable treatment of certain plan distributions undercuts retirement saving by encouraging early and lump sum withdrawals. The ability of individuals to gain access to the tax advantages provided to tax-favored funds before retirement permits employees to use tax-favored plans as short-term savings accounts rather than as retirement savings vehicles. Also, the special basis recovery rules for early distributions permit the accelerated tax-free recovery of employee contributions and thus further encourage the use of tax-favored plans for nonretirement purposes.

The special ten-year averaging and capital gain provisions for lump sum distributions (including lump sum distributions before retirement) encourage individuals to withdraw tax-favored funds from the retirement income stream and thus are inconsistent with the policy to provide individuals with income throughout the entire period of retirement. The original purpose of the capital gain and ten-year averaging provisions was to mitigate the effect of the progressive tax structure on individuals receiving all of their benefits in a single year. The same purpose is now served, however, by permitting individuals to roll over distributions into an IRA. This results in the individual being taxed only as amounts are subsequently withdrawn from the IRA.

Finally, the rules permitting the deferral of tax on unrealized appreciation in employer securities encourage the investment and receipt of tax-favored funds in the form of such securities. The opportunity to defer tax even after distribution (and to escape tax altogether if the securities are unsold at death) permits the use of tax-favored plans for nonretirement purposes, such as the accumulation of funds to pass on to beneficiaries on a tax-favored basis. In addition, individuals are able to avoid having to sell employer securities upon distribution in order to pay the tax due by rolling the securities over into an IRA.

Proposals

Uniform Minimum Distribution Rules. All tax-favored plans, including tax-sheltered annuities, would be subject to uniform minimum distribution rules governing both lifetime and after-death distributions. Thus, distributions from all employer-maintained plans would be required to commence no later than the April 1 following the year in which the individual attains age 70-1/2 or, if later and the individual is not a five percent owner, the year in which the individual retires. Distributions from IRAs would be required to commence no later than April 1 following the year in which the individual attains age 70-1/2. Thereafter, both lifetime and after-death distributions would have to conform with minimum payout schedules. Certain simplifying modifications would be made to the existing rules to ease the calculation and improve the predictability of required annual distributions.

The uniform sanction for failure to satisfy the minimum distribution rules would be a nondeductible excise tax equal to 50 percent of the amount by which the minimum amount required to be distributed exceeds the amount actually distributed. The recipient of the distribution would be primarily liable for payment of the tax, with a right, in appropriate cases, to recover the tax from the plan. The current sanction of disqualification would be eliminated.

Distribution Restrictions. Tax-sheltered annuities, including annuity contracts and retirement income accounts, would be subject to the distribution restrictions currently applicable only to custodial accounts. Financial hardship would be eliminated as an event permitting distributions. Thus, early distributions from all tax-sheltered annuities would generally be prohibited absent separation from service, the attainment of age 59-1/2, death, or disability.

Uniform Tax Treatment of Distributions, Including Lump Sum Distributions. Uniform rules would govern the tax consequences of plan distributions to individual recipients. Thus, distributions would be subject to tax only upon actual receipt. Current application of the constructive receipt doctrine to tax-sheltered annuities would be eliminated. In addition, the taxable portion of any distribution from a tax-favored plan would be taxed fully as ordinary income. The special capital gain and ten-year averaging treatment for lump sum distributions and the deferred inclusion of unrealized appreciation on distributions of employer securities would be eliminated.

In calculating the taxable portion of a plan distribution, the generally applicable basis recovery rules, with certain modifications, would apply. Thus, an amount received before the annuity starting date would be treated, first, as a taxable distribution and, second, as a nontaxable return of basis. Annuity distributions after the annuity starting date would be taxed in accordance with the exclusion ratio established when such distributions commenced; the three-year recovery rule would be eliminated. In establishing the exclusion ratio for an individual, standardized recovery periods of multiples of five years would be used in lieu of the individual's actual life expectancy; the recovery period for a particular individual would be the period closest to the individual's life expectancy at the time distributions commence. If distributions cease before the individual recovers his entire basis tax-free, the individual, his estate, or his heirs would be entitled to deduct the unrecovered basis. If the individual receives benefits for longer than his recovery period, all additional distributions would be fully taxable.

Recapture Tax on Early Distributions. Early distributions from tax-favored plans would be subject to uniform treatment. The taxable portion of an early distribution from any tax-favored plan would be subject to an excise tax of 20 percent designed to recapture some portion of the tax advantages provided with respect to the distributed funds. However, if the early distribution is used to pay for college expenses incurred by a dependent, for the purchase of the individual's first principal residence, or to replace unemployment benefits during a period of unemployment following the cessation of such benefits, the rate of the recapture tax would be reduced to ten percent. In any case, the tax would be nondeductible and could not be offset by any deductions or credits otherwise available to the individual. A distribution would be treated as an early distribution if it is made before the individual's death, disability, or attainment of age 59-1/2. However, a distribution before the attainment of age 59-1/2 (but not before the attainment of age 50) would not be treated as an early distribution if it is one of a scheduled series of substantially level payments under a single or joint life annuity or under a term certain of at least 180 months commencing upon retirement under the plan.

Rollovers. Individuals generally would be permitted to make tax-free rollovers of funds, within 60 days, between tax-favored plans. Rollovers and transfers would be limited, however, to prevent individuals from thereby avoiding the minimum distribution rules.

Effective Date

The proposed rules governing distributions generally would apply to distributions from tax-favored plans on or after January 1, 1986, in years beginning on or after such date. The following transition rules, however, are proposed with respect to certain of the rules.

The extension of uniform minimum distribution rules and early distribution restrictions to all tax-sheltered annuities would not apply to annuities with respect to which no additional contributions are made on or after January 1, 1986.

The repeal of capital gain and ten-year averaging treatment of lump sum distributions for individuals who, as of January 1, 1987, will have attained age 55 would be phased in over a six-year period. Under this transition rule, five percent of a lump sum distribution received in 1987 would not qualify for capital gain or ten-year averaging treatment; 25 percent would not qualify in 1988; 50 percent in 1989; 75 percent in 1990; and 100 percent in 1991. For all other individuals, the repeal of capital gain and ten year averaging treatment would be fully effective for distributions on or after January 1, 1986.

The repeal of the deferred inclusion of unrealized appreciation on employer securities would be phased in under the same rule. Thus, for individuals who will have attained age 55 by January 1, 1987, five percent of the unrealized appreciation on each employer security received in 1987 would not qualify for nonrecognition; 25 percent in 1988; 50 percent in 1989; 75 percent in 1990; and 100 percent in 1991. Again, for all other individuals, repeal of the deferred inclusion rule would be fully effective for distributions on or after January 1, 1986.

The proposed modification to the basis recovery rule for distributions before the annuity starting date would not apply to benefits accrued under a plan as of January 1, 1986. Also, distributions after such date will be treated, first, as distributions of benefits accrued as of January 1, 1986 and, thereafter, as distributions of benefits accrued after January 1, 1986. Thus, for example, if an employee's accrued benefit as of January 1, 1986 includes employee contributions, non-annuity distributions after January 1, 1986 would be treated, first, as distributions of employee contributions made before January 1, 1986; second, as distributions of taxable benefits; and, third, as distributions of employee contributions made after January 1, 1986.

The proposed modification to the three-year basis recovery rule and the exclusion ratio would not be effective with respect to amounts received as an annuity after the annuity starting date if such annuity was in pay status as of January 1, 1986. The recovery rules of current law would continue to apply to such amounts.

Analysis

The recapture tax on early distributions and the minimum distribution rules are intended to target the tax-favored treatment of plans at retirement savings. The tax is not designed as a penalty, but rather to recoup some portion of the unintended tax advantages that can be obtained by using tax-favored funds for nonretirement purposes, including colleges expenses and the purchase of a residence. As funds are permitted to accumulate for longer periods of time, the advantages of saving in a tax-favored vehicle increase relative to saving in a taxable vehicle. Thus, after funds have accumulated for a certain number of years, the recapture tax will recoup only a portion of the tax advantages provided with respect to the funds, and as the accumulation period increases, the recouped portion decreases. Concomitantly, the minimum distribution rules limit the ability of individuals to defer the receipt of retirement savings beyond retirement or to transfer such tax-favored accumulations to succeeding generations.

The elimination of capital gain and ten-year averaging treatment for lump sum distributions would not subject individuals using their tax-favored benefits for retirement purposes to significant adverse tax effects. Except to the extent precluded under the minimum distribution rules, an individual receiving a large distribution from a tax-favored plan could still avoid a large tax liability by rolling over some or all of such benefits to an IRA or other qualified plan. This would be consistent with the basic objective of promoting tax-favored distributions over an individual's entire retirement period. Also, even though the relative advantages of ten-year averaging treatment may be greater for smaller lump sum distributions, it is important that the tax rules not create incentives for individuals, particularly lower-paid individuals, to divert tax-favored funds from the retirement income stream before retirement.

The proposed modifications to the calculation of the exclusion ratio applicable to distributions after the annuity starting date would assure that an individual (or his estate or heirs) would receive the individual's after-tax investment in the plan without additional tax. Also, the modifications would assure that an individual who outlives his life expectancy would not receive significant amounts in excess of his after-tax investment without tax. Finally, the use of standardized recovery periods would simplify the calculation and application of the exclusion ratio by taxpayers and would facilitate the administration and enforcement of such rules by the Internal Revenue Service.

MODIFY DEDUCTION RULES FOR TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.03

Current Law

In general, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of employees. Moreover, income on amounts set aside by an employer to fund deferred compensation is generally taxable to the employer as earned. Exceptions to these general rules are provided for deferred compensation provided under the various types of tax-favored plans. Thus, within certain limits, employer contributions to such plans are currently deductible by the employer even though employees will not be taxable until they receive distributions from the plans. In addition, the income earned on assets held in a tax-favored plan is not subject to tax while it remains in the plan.

An employer's deduction for contributions to a tax-favored plan is subject to two separate limitations. The first applies on an individual-by-individual basis and covers contributions to defined contribution plans (i.e., profit-sharing, stock bonus, and money purchase pension plans), defined benefit plans, and combinations of the two. The second limitation applies plan by plan and is based on the total contributions for the group of employees covered by the particular plan. This group-based limitation applies to pension plans (i.e., money purchase pension plans and defined benefit pension plans), profit-sharing and stock bonus plans, and combinations thereof.

The individual-by-individual limitation is as follows: (i) the contributions and other additions on behalf of an individual under a defined contribution plan for a year may not exceed the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation for the year; (ii) the contribution to a defined benefit plan to fund an individual's annual retirement benefit may not exceed the contribution necessary, under reasonable actuarial methods, to fund an annual retirement benefit of $90,000 (indexed beginning in 1988); and (iii) the total contributions with respect to an individual covered by both a defined contribution plan and a defined benefit plan may not exceed a particular percentage (less than 100 percent, and dependent on the individual's compensation) of the sum of the two preceding limits. In addition to being nondeductible, contributions in excess of these limits may also trigger disqualification of the plan.

The group-based limitation applies different limits to pension plans and to profit-sharing and stock bonus plans. An employer's deduction for contributions to a pension plan is subject to limitations based on the minimum funding standards applicable to pension plans and on certain other actuarial determinations. An employer's deduction for contributions to a profit-sharing or stock bonus plan is limited to 15 percent of the aggregate compensation paid during the taxable year to all employees in the plan. A carryforward of the unused portion of the 15 percent limit to a succeeding year is permitted, subject to an overall 25 percent of aggregate compensation limit for the succeeding year. Excess contributions may be carried forward and deducted in a succeeding year, subject to the 15 percent of compensation limit for such year.

If an employer contributes to both a pension plan and a profit-sharing or stock bonus plan, the total deduction for a year is limited to the greater of (i) 25 percent of the aggregate compensation paid during the year to the employees covered by the plans, or (ii) the amount of contribution to the pension plan necessary to satisfy the minimum funding standards for such year. An employer may carry forward excess contributions to a succeeding year, but the deduction of current and carryforward contributions for any year is limited to 25 percent of compensation paid for such year.

The group-based deduction limitation also provides special rules with respect to the deductibility of contributions to employee stock ownership plans ("ESOPs"), which in general are profit-sharing, stock bonus, or money purchase pension plans that invest primarily in employer securities. Contributions to an ESOP to repay principal and interest on a loan incurred by the ESOP for the purpose of buying employer securities may be deductible even though they are in excess of the generally applicable limits. In addition, an employer may be allowed a tax credit in lieu of a deduction for contributions to an ESOP for up to 0.5 percent of the aggregate compensation paid during the year to employees under the ESOP. This tax credit is scheduled to expire at the end of 1987.

Reasons for Change

The limitations on an employer's deduction for qualified plan contributions are intended to restrict the tax-favored treatment associated with such plans for individual employees to amounts necessary to provide a reasonable level of retirement income security. Amounts in excess of these limitations are presumptively in excess of the amounts necessary to provide reasonable benefits and should not be eligible for tax advantages.

The current group-based limitation on deductible plan contributions is intended to be more restrictive for contributions to plans that may be used to finance current consumption or otherwise serve nonretirement purposes. Thus, employer deductions for contributions to profit-sharing and stock bonus plans have been subject to greater restrictions, since, unlike pension plans, profit-sharing and stock bonus plans are not subject to minimum funding requirements and generally are more liberal in permitting pre-retirement distributions.

Although profit-sharing and stock bonus plans are thus appropriately subject to greater limitations than pension plans, the current 15 percent of aggregate compensation limit on the deductibility of contributions to profit-sharing and stock bonus plans is not fully effective in restricting the use of these plans. The effectiveness of the 15 percent limit is undermined by the carryforward rules and, in certain situations, the ability of employers to contribute more than 15 percent of compensation for highly paid individuals and less than 15 percent for lower-paid individuals.

In addition, the 25 percent of aggregate compensation deduction limit applies only to combinations of profit-sharing or stock bonus plans and pension plans, rather than to combinations of defined contribution plans and defined benefit pension plans. As a result, an employer may make contributions to a money purchase pension plan and a defined benefit pension plan without regard to the 25 percent of aggregate compensation limit, even though money purchase pension plans are essentially equivalent to profit-sharing and stock bonus plans in that the benefit provided under each is based entirely on the individual's account balance at the time of retirement.

The special tax treatment of ESOPs cannot be justified on retirement policy grounds. ESOPs are not primarily retirement plans, but rather are aimed at promoting employee ownership of employer stock and at facilitating employers in raising capital.

Proposals

The 15 percent of aggregate compensation limit on deductions for contributions to profit-sharing and stock bonus plans would be eliminated. The current annual limit on the deductibility of the contributions for any individual in a defined contribution plan would be modified so that the contributions to a profit-sharing or stock bonus plan for any individual could not exceed 15 percent of such individual's compensation for the year. Contributions in excess of this limit would be deductible in a succeeding year subject to the 15 percent of compensation limit for that year.

Under the 15 percent of individual compensation deduction limit, a carryforward of an unused limit to a succeeding year would generally be prohibited. There would be an exception to this general rule, however, for employer contributions with respect to a "retirement-type" profit-sharing plan. Under the exception, there would be a carryforward of any unused portion of the 15 percent deduction limit with respect to a participant from one year to a subsequent year only if the profit-sharing plan is a "retirement-type" plan with respect to such participant for each year during the period beginning ten years before the year in which the unused limit arose through the year to which the unused limit is to be carried forward. In any case, the deduction limit with respect to a participant for any year, i.e., the sum of the new deduction limit plus the unused limit carried forward from any prior year, could not exceed 25 percent of the individual's compensation for such year.

For purposes of this rule, a profit-sharing plan would be treated as a "retirement-type" plan with respect to an individual for a year only if the following conditions are satisfied for such year: (1) the individual is an active participant under the plan; (2) the individual is not a participant in any other qualified profit-sharing or stock bonus plan maintained by the employer; (3) contributions on behalf of the individual are based on a contribution or allocation formula using a reasonable year-of-service factor; (4) employer-derived benefits attributable to the year and to any other year for which the plan was a "retirement-type" plan are not available, either by distribution or loan, before separation from service, death, or disability; and (5) the plan is not top-heavy.

The 25 percent of aggregate compensation limit on deductions for total contributions to combinations of pension plans and profit-sharing or stock bonus plans would be modified by applying the limit to combinations of defined contribution plans and defined benefit plans. Thus, if an employer maintains a money purchase pension plan and a defined benefit pension plan, the employer's deduction for total contributions to both plans would be limited to the greater of (1) 25 percent of the aggregate compensation paid to the employees covered by the plans, or (2) the amount necessary to satisfy the minimum funding standard for the defined benefit plan.

An excess contribution to a tax-favored plan would generally not trigger plan disqualification, but rather would be subject to an annual tax of ten percent for the year of contribution and for as long as the excess contribution both remained in the plan and was nondeductible.

The special rules for ESOPs--the tax credit and the special deduction limits for ESOP contributions to repay principal and interest on securities acquisition loans--would be eliminated. Thus, the deductibility of contributions to a tax-favored plan designed to invest primarily in employer securities would be governed by the generally applicable deduction limits. See Ch. 12.06.

Effective Date

The proposals generally would be effective for years beginning on or after January 1, 1986. A special rule would permit an employer to deduct contributions to a retirement-type profit-sharing or stock bonus plan for the benefit of an individual in excess of the 15 percent of individual compensation limit where annual contributions of less than 15 percent had been made on behalf of such individual before the effective date. In addition, a special rule would permit the deduction of excess contributions carried forward from years before the effective date.

The repeal of the special deduction limits for ESOP contributions to repay securities acquisition loans would not be effective with respect to ESOP contributions to repay principal and pay interest on securities acquisition loans outstanding on December 31, 1985. Securities acquisition loans outstanding on December 31, 1985 that are renegotiated, extended, renewed, or revised on or after that date generally would be treated as new loans made on the date of modification. In addition, the tax credit for contributions to ESOPs would be permitted to expire as scheduled at the end of 1987.

Analysis

The annual ten percent tax on accumulated excess contributions is intended to offset the advantage of tax-free accumulation to which excess contributions are currently entitled. The tax would parallel the tax currently applicable to excess contributions to a tax-sheltered annuity contract or custodial account, individual retirement account or simplified employee pension, except that it would apply to the year of contribution without regard to whether the excess contributions were distributed within any specified period.

The 15 percent of individual compensation deduction limit on contributions to profit-sharing and stock bonus plans is intended to be a more effective limitation on such plans where they are not designed as retirement plans, which is generally the case. However, the special carryforward rule recognizes that profit-sharing and stock bonus plans may be designed to function as retirement plans and, where this is the case, a 15 percent lifetime limit is more appropriate than a 15 percent annual limit.

MODIFY ANNUAL LIMITS ON CONTRIBUTIONS AND BENEFITS UNDER TAX-FAVORED PLANS

General Explanation

Chapter 14.04

Current Law

Current law provides favorable tax treatment to funds set aside in employer-maintained plans that satisfy certain qualification requirements. Among the qualification requirements applicable to such plans are restrictions on the annual contributions and benefits that may be provided with respect to any individual under the defined contribution plans and defined benefit plans of an employer. For this purpose, defined contribution plans generally include profit-sharing, stock bonus, money purchase pension, and annuity plans, tax-sheltered annuities, and simplified employee pensions. Defined benefit plans for this purpose are limited to defined benefit pension plans. Separate annual limits apply to each individual in a defined contribution plan and to each individual in a defined benefit plan ("separate plan limits"). An "overall limit" also applies to each individual covered by both a defined contribution plan and a defined benefit plan.

The separate plan limit for a defined contribution plan provides generally that the annual contributions, forfeitures, and other additions for any individual may not exceed the lesser of $30,000 (indexed for inflation beginning in 1988) or 25 percent of the individual's compensation for such year. In determining whether the applicable limit is satisfied with respect to an individual for a year, the lesser of (i) one-half of the employee contributions for the year or (ii) the excess of the employee contributions for the year over six percent of the individual's compensation for the year are treated as annual additions.

Special rules permit the employees of certain tax-exempt organizations, such as educational institutions, hospitals, and churches, to benefit from contributions and other additions to tax-sheltered annuities in excess of the general defined contribution plan limits. Similarly, special limits applicable to employee stock ownership plans (ESOPs) permit contributions to exceed the general limits for defined contribution plans.

The separate plan limit for a defined benefit plan provides that the benefit payable with respect to an individual for a year, when expressed as an annual retirement benefit, may not exceed the lesser of $90,000 (indexed for inflation beginning in 1988) or 100 percent of the average of the individual's highest three years of compensation. The defined benefit limit is not violated if the annual benefit payable to an individual who has never participated in a defined contribution plan is not in excess of $10,000. If an individual has less than ten years of service with an employer, the $90,000, the 100 percent of compensation, and the $10,000 annual benefit limits are reduced on a pro rata basis.

The overall limit coordinates the contributions and benefits that may be provided to an individual covered by both a defined contribution plan and a defined benefit plan. Calculation of the overall limit is complex, requiring that the sum of the defined contribution fraction and the defined benefit fraction for any individual subject to the separate plan dollar limits for any year not exceed 1.25. For an individual who is subject to the separate plan percentage-of-compensation limits, rather than the dollar limits, the sum of the fractions may not exceed 1.4. The numerator of an individual's defined contribution fraction is the aggregate additions made on behalf of the individual under the plan during all years of the individual's participation, and the denominator is the sum of each of the separate defined contribution plan limits that applied, or would have applied, for each of the individual's years of service with the employer. The defined benefit fraction is the individual's accrued annual retirement benefit over the applicable separate defined benefit plan limit for the year.

In the case of a "top-heavy" plan, i.e., a plan under which more than 60 percent of the total accrued benefits are for key employees (five percent owners, one percent owners with $150,000 in compensation, the ten employees with the largest ownership interests, and officers), the 1.25 limit on the sum of the defined contribution and defined benefit fractions for key employees subject to the separate plan dollar limits is reduced to 1.0. If, however, accrued benefits for the key employees are not greater than 90 percent of the total accrued benefits under the plan and if the non-key employees are provided with the required additional minimum contributions or benefits, the overall limit for key employees subject to the dollar limits is increased from 1.0 to 1.25.

Reasons for Change

The separate plan and overall limits on annual contributions and benefits reflect a policy that favorable tax treatment should be available only up to levels needed for reasonable retirement savings. The limits under current law, however, are unnecessarily complex and fail to limit the use of tax-favored plans in a consistent or equitable manner.

Calculation of the overall limit imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area. It requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored plans.

The overall limit also creates a disincentive for employers to establish both defined contribution and defined benefit plans, since the aggregate contributions and benefits for an individual may not exceed a particular percentage (less than 100 percent, and dependent on the individual's compensation) of the sum of the separate plan limits. In most situations, the maintenance of both a defined contribution plan and a defined benefit plan would better serve the interests of employees generally; younger, more mobile employees tend to be favored by defined contribution plans, while older employees, particularly those close to retirement, generally are favored by defined benefit plans.

The effectiveness of the current limits is undermined by the inconsistency in their application. The separate and overall limits fail to take into account benefits under such tax-favored plans as individual retirement accounts (IRAs). In addition, certain individuals (e.g., participants in tax-sheltered annuities and ESOP participants) are permitted to receive annual contributions and benefits in excess of the generally applicable limits. Moreover, the limits consider only the contributions and benefits provided to an individual by a single employer; individuals who have accrued tax-favored benefits with more than one employer may receive total contributions and benefits far in excess of the existing limits. Finally, the limits do not effectively restrict the tax-favored benefits (as compared to the tax-favored contributions) that may be provided to an individual under a defined contribution plan.

In addition, the current limits fail to count all employee contributions and thus disregard the tax advantages such contributions receive. Although not deductible, employee contributions to a tax-favored plan may accumulate income on a tax-deferred basis. Also, highly-paid individuals generally are in a better position to take disproportionate advantage of the tax benefits for employee contributions.

Finally, the phase-in of the annual defined benefit limits over an individual's first ten years of service with an employer fails to preclude the key employee of an employer, typically a small employer, from delaying the establishment of a defined benefit plan until such employee is close to retirement. Because such a key employee generally will have in excess of ten years of service with the employer, the employee may be provided with a benefit under the defined benefit plan up to the full, unreduced annual limit. By delaying the establishment of the plan, however, the employer is able to avoid providing benefits to non-key employees who may have worked for the employer in earlier years.

Proposals

The overall limit on the annual contributions and benefits that may be provided to an individual under a defined contribution plan and a defined benefit plan of an employer would be eliminated. For top-heavy plans, however, the existing overall limits would continue to apply.

An additional tax would be applied to taxable, tax-favored benefits distributed to or with respect to a participant from all plans, including IRAs and tax-sheltered annuities, to recapture some portion of the tax advantages provided with respect to annual benefits in excess of reasonable levels. The recapture tax would be ten percent of the amount by which such annual benefits exceed 1.25 times the defined benefit dollar limit in effect for the year. The tax would be nondeductible for income tax purposes, and losses, deductions, and credits would not be applicable against the tax. Finally, the ten percent tax on excess annual distributions would be coordinated with the 20 percent recapture tax on early distributions (see Ch. 14.02) so that the same amounts are not subject to both recapture taxes.

In determining whether the separate plan limit for an employee in a defined contribution plan is satisfied, one-half of all employee contributions would be treated as annual additions on behalf of the employee. In addition, the special limits for employees of certain tax-exempt organizations participating in tax-sheltered annuities and for employees participating in ESOPs would be eliminated.

Finally, the phase-in of the separate defined benefit plan limit over ten years of service with the employer would be modified by providing for a phase-in of the $90,000 annual defined benefit dollar limit over the first ten years of plan participation. A minimum annual benefit would be permitted, however, for low-paid employees near retirement with significant years of service at the time plan participation commences.

Effective Dates

The modifications to the annual limits on contributions and benefits would apply to plan limitation years beginning on or after January 1, 1986. For collectively bargained plans, these modifications would apply to limitation years beginning after termination of the collective bargaining contract. The ten percent recapture tax on annual distributions in excess of the applicable dollar amount would apply to tax-favored distributions made on or after January 1, 1986, in taxable years of individual recipients beginning on or after such date.

The phase-in of the defined benefit dollar limit over an employee's first ten years of plan participation would itself be phased in according to the following schedule: for limitation years beginning in calendar year 1986, the applicable limit would be determined by applying a two years of participation phase-in rule; for years beginning in 1987, a three years of participation phase-in would apply; and so forth until for years beginning on or after January 1, 1994, the applicable dollar limit would be determined under a ten years of participation rule.

Analysis

Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus should promote the adoption of tax-favored plans. It should also provide employers with a significant incentive to maintain both defined contribution plans and defined benefit plans.

The ten percent tax on annual tax-favored distributions in excess of 1.25 times the applicable defined benefit dollar limit for the year is an appropriate limit on an individual's annual tax-favored retirement benefits. This tax is not designed as a penalty, but rather to recapture a portion of the tax advantages provided to excess benefits, without requiring significant employer involvement and without encouraging employers to maintain only one type of plan. By applying at the individual level, rather than on an employer-by-employer basis, the recapture tax also would apply to individuals who accrue excess benefits from multiple employers, without imposing significant administrative burden; the current limits fail to prevent a doubling up of benefits through multiple employers. For example, if in 1986 an individual receives total tax-favored retirement benefits of $200,000 from any number of employers, the excess of the $200,000 over $112,500, or $87,500, would be subject to the ten percent tax.

Of course, unless required to take a distribution into income by the minimum distribution rules, an individual may avoid the ten percent recapture tax on an excess distribution by rolling over some or all of such distribution to an IRA or qualified plan.

APPLY TEN PERCENT RECAPTURE TAX TO QUALIFIED PLAN ASSETS REVERTING TO EMPLOYER

General Explanation

Chapter 14.05

Current Law

As a general rule, amounts paid as deferred compensation are deductible by an employer only as they are included in the income of the employee. Moreover, income from amounts set aside to fund deferred compensation is fully taxable to the employer as it is earned. Current law provides exceptions to these general rules for employer contributions to defined benefit plans. Thus, within certain limits, employer contributions to defined benefit plans are currently deductible, even though employees are not taxable until they receive distributions from the plan. In addition, income generated from plan assets is exempt from tax until distributed by the plan. These tax advantages are intended to encourage the creation of qualified plans and thus to improve the retirement income security of employees.

Current law requires employers to fund defined benefit plans on a "going concern," rather than a "termination," basis; i.e., employers must fund not merely benefits already accrued, but also some portion of the plan's projected benefits. Current minimum funding standards also provide that experience gains (e.g., better-than-expected claims or earnings experience) may not be taken into account in a single year for purposes of determining required contributions, but rather must be amortized over a fifteen-year period. As a result of these funding standards, and because employers may also receive a deduction for certain plan contributions in excess of minimum funding requirements, the funds in a defined benefit plan at any particular time may exceed the amount necessary to fund benefits accrued as of such time.

Although current law generally prohibits the use of plan assets by the employer, upon termination of a plan the employer may receive plan assets in excess of those necessary to fund fixed and contingent benefits as of the date of termination. Plan assets that revert to the employer upon termination generally are included in the employer's gross income.

Reasons for Change

Current law permits employers to gain unintended tax advantages by receiving tax-favored assets on plan termination. Although plan assets reverting to the employer are includable in its income, the employer retains the benefit of an initial deduction and of tax-deferral on the plan's income. As assets accumulate over longer periods of time in tax-favored plans, the value of these tax advantages becomes quite substantial. Such tax-favored treatment is inappropriate where plan assets are not used to provide retirement benefits to employees.

The problem is not limited to the situation where an employer intentionally overfunds and later terminates a defined benefit plan to gain the tax-favored funds. It also includes the situation where an employer, for independent business reasons, terminates a defined benefit plan that has become overfunded solely due to the performance of the plan's investments. In both situations, the employer is receiving the benefit of tax advantages that should be available only for retirement purposes.

The use of defined benefit plans for nonretirement purposes is evidenced in a number of recent cases in which employers have undertaken transactions that effectively permit the employer to receive assets from a defined benefit plan while continuing to maintain a defined benefit plan for its employees. These transactions are inconsistent with the minimum funding standards for qualified defined benefit plans and may undermine the security of the promised benefits in the continuing plans. The Treasury Department, along with the Labor Department and the Pension Benefit Guaranty Corporation, has issued current law guidelines regarding these transactions; these guidelines should effectively guard against many of the potential abuses related to plan terminations. However, because the guidelines are issued within the confines of existing administrative authority, they do nothing to recapture any portion of the tax advantages provided to defined benefit plan funds when such funds revert to the employer.

Proposal

An excise tax of ten percent of the plan funds reverting to the employer upon plan termination would be imposed on such employer to recapture some portion of the tax advantages provided with respect to such funds. This tax would be nondeductible for income tax purposes, and could not be offset by losses or other deductions or credits.

Effective Date

The ten percent recapture tax would apply to qualified plan assets reverting to an employer pursuant to a plan termination occurring on or after January 1, 1986.

Analysis

The recapture tax on plan assets reverting to an employer would parallel the tax on early distributions to individuals from tax-favored plans. Thus, it is designed not as a penalty on asset reversions, but rather to recapture a portion of the substantial tax advantages provided with respect to a terminating plan's assets when such assets are not used to provide benefits under the plan. Under the minimum funding rules currently applicable to defined benefit plans, an employer is effectively able to gain the benefit of excess plan assets by reducing its plan contributions over a five to ten year period. This approach, however, does not enable the employer to gain currently the benefit of the tax advantages provided with respect to plan assets, is fully consistent with the "going concern" approach of the funding standards, and does not create special risks about the security of employees' future retirement benefits.

REVISE CASH OR DEFERRED ARRANGEMENT (SECTION 401(K)) AND EMPLOYER MATCHING CONTRIBUTION RULES

General Explanation

Chapter 14.06

Current Law

Cash or Deferred Arrangements. In general, employees are subject to tax not only on compensation actually received, but also on amounts the receipt of which is, at the employee's election, deferred until a later year. An exception to this rule of constructive receipt is provided for so-called cash or deferred arrangements ("CODAs"), under which an employee may elect to defer the receipt of cash compensation and have the deferred amount contributed as an "elective contribution" to a qualified profit-sharing or stock bonus plan. If the CODA meets certain qualification requirements, the employee is not currently taxable on his or her elective contributions.

A taxable employer may maintain a qualified profit-sharing plan and thus may maintain a CODA. Congress has not directly addressed these questions, however, with respect to either tax-exempt employers or public sector employers, such as states or local governments.

A CODA is qualified if (1) the elective contributions are wholly nonforfeitable immediately upon contribution; (2) the elective contributions may not be distributable before the earlier of age 59-1/2, hardship, separation from service, disability, or death; (3) the employees eligible to make elective contributions under the CODA satisfy the coverage requirements generally applicable to qualified plans; and (4) the elective contributions satisfy the "actual deferral percentage test" (the "ADP test").

Under the coverage requirements generally applicable to qualified plans, the maximum year-of-service condition for eligibility to make elective contributions under a CODA is three years of service. Also, such coverage rules require that the employees eligible to make elective contributions under a CODA constitute either (1) at least 70 percent of all nonexcluded employees who have satisfied the applicable age and service conditions, or (2) a classification of nonexcluded employees that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. Excluded employees are those employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are nonresident aliens without U.S. earned income.

The ADP test is satisfied for a year if either (1) the ADP for the "highly compensated employees" for the year is not more than 150 percent of the ADP for all other eligible employees, or (2) the ADP for the "highly compensated employees" is not more than 250 percent of the ADP for all other eligible employees and is not more than 3 percentage points greater than the ADP for all other eligible employees. The ADP for a group of employees for a year is the average of the separate deferral ratios for each employee in the group; an employee's deferral ratio for a year is the ratio of the employee's elective contributions for the year to the employee's compensation for the year. For purposes of the ADP test, "highly compensated employees" are those employees who are more highly compensated than two-thirds of all employees eligible to make elective contributions under the CODA.

Elective contributions to CODAs are treated as employer contributions for purposes of applying the annual contribution and benefit limits that apply generally to tax-favored defined contribution plans. Thus, if allowed under the ADP test, the maximum elective contribution to a CODA on behalf of any employee who does not participate in another tax-favored plan is the lesser of $30,000 (indexed beginning in 1988) or 25 percent of the individual's compensation.

Employer Matching Contributions. An employer may coordinate its own contributions to a tax-favored plan with either after-tax employee contributions to such plan or with elective contributions under a CODA that is part of such plan. Employee contributions that are a condition of an employer-provided contribution or benefit are labeled "mandatory contributions," and employer contributions that are geared to either mandatory employee contributions or mandatory elective contributions are "employer matching contributions."

Employer contributions to a tax-favored plan must satisfy the general nondiscrimination rule, which generally requires that contributions or benefits under the plan not discriminate in favor of employees who are officers, shareholders, or highly compensated (the prohibited group members). This rule is normally satisfied if the employer contributions on behalf of employees are a uniform percentage of the employees' compensation. Under certain circumstances, employer contributions may satisfy this general rule, even though they are not a uniform percentage of compensation, because the plan takes the employer's social security contributions into account or because such contributions actuarially produce nondiscriminatory benefits. There is significant uncertainty, however, regarding the application of the general nondiscrimination rules to employer matching contributions.

Nonelective employer contributions (including employer matching contributions) on behalf of an employee under a plan containing a CODA may be treated as elective contributions for purposes of determining the deferral ratio for such employee if the nonelective contributions are wholly nonforfeitable upon contribution and are subject to the distribution rules applicable to elective contributions. Thus, such nonelective contributions may be combined with elective contributions under a CODA to determine whether the elective contributions satisfy the ADP test. Such nonelective contributions, however, still must separately satisfy the general nondiscrimination rule.

Reasons for Change

The tax-favored treatment made available to employer-maintained and individual plans should be directed primarily at enhancing retirement income security. Consistent with this policy, the ability to make elective contributions to tax-favored plans should be available to individuals on a broad and consistent basis.

An elective contribution under a CODA has the same economic and tax effect for the employee as a deductible contribution by the employee to an individual retirement account ("IRA"). Despite this equivalence, the limits on elective contributions under a CODA are far more liberal than the IRA contribution limits. Current law thus provides tax advantages to employees of employers maintaining CODAs that substantially exceed those available to other individuals.

Some greater liberality in the limitations on CODA contributions is appropriate because of the effectiveness of CODAs in encouraging employees to save for retirement. The most important CODA feature is flexibility: employees need not make elective contributions unless their own financial circumstances permit. A higher annual limit on elective contributions facilitates this flexibility by enabling employees to catch up in a subsequent year for not having made elective contributions in an earlier year. Many employers make employer matching contributions with respect to elective contributions, thereby further enhancing employee participation. The availability of plan loans, distributions upon hardship or separation from service, and numerous investment options also add to the relative attractiveness of CODAs. Finally, some claim that employers that would not otherwise adopt tax-favored plans are adopting CODAs.

If liberal CODA contribution limits are to be justified because of the effectiveness of CODAs in encouraging employee retirement saving, such limits should be applicable only to the extent elective contributions actually are made by broad cross-sections of employees on a nondiscriminatory basis; nondiscriminatory availability alone is insufficient to justify more favorable treatment. The existing CODA rules, however, permit employers to exclude many employees from eligibility, and permit excessive disparity between the elective contributions by highly compensated employees and the elective contributions by other eligible employees.

In addition, because the ADP test applies on an average basis and treats a broad category of employees as "highly compensated" (e.g., surveys indicate that the compensation breakpoint between the "highly compensated employees" and other eligible employees often is less than $30,000), it is not uncommon for certain very highly paid employees to make elective contributions far in excess of the maximum ADP permitted for highly compensated employees generally. Although employee participation at the lower and middle income levels may be greater in CODAs than in IRAs, the disparity in contributions and benefits in favor of the highly paid employees generally is greater in CODAs than in other defined contribution plans. This disparity can be reduced without affecting the most important feature of CODAs, i.e., employee flexibility.

Tax-exempt employers and public sector employers each have access to their own tax-favored elective contribution plans for retirement savings. Tax-exempt employers may offer their employees tax-sheltered annuities and public sector employers may permit employees to make elective deferrals under eligible State deferred compensaton plans (see Ch. 14.10) and, in some cases, to tax-sheltered annuities; coordination rules are provided for public sector employees who participate in both types of tax-favored elective deferral arrangements. Thus, the extension of CODAs to tax-exempt and public employers would be inappropriately duplicative.

Employers should be encouraged to make employer matching contributions for employees on a fully nonforfeitable basis and subject to the CODA distribution restrictions. In addition, the application of the general nondiscrimination rules to employer matching contributions should be clarified. Uncertainty about the applicable rules hinders some employers in fully utilizing plans with employer matching contributions and permits other employers to provide excessive contributions and benefits for highly paid employees. As is the case with other tax-favored contributions to and benefits in employer-maintained plans, it is important to assure that employer matching contributions are actually being provided to broad cross-sections of employees on a nondiscriminatory basis. Employers should not be permitted to design plans using employer matching contributions as mechanisms to deliver disproportionate tax-favored benefits to highly paid employees. Accordingly, appropriate nondiscrimination rules should be applied to employer matching contributions.

Proposals

CODA (401(k)) Rules. The rules governing CODAs would be modified so that an employee's elective contributions for a year would be limited to $8,000. Elective contributions would continue to count as employer contributions against the annual contribution and benefit limits for tax-favored plans.

Deductible IRA contributions by an individual for a year would count against the dollar limit on elective contributions under a CODA by such individual for the plan year beginning in the calendar year to which the IRA contributions relate. Thus, if an individual with $20,000 in compensation makes a $2,000 IRA contribution for 1987, the dollar limit on the CODA contributions by such individual for the plan year beginning in 1987 would be reduced by $2,000.

The ADP test for CODAs would be modified in a number of ways. First, the prohibited group members in applying the ADP test for a year would not be the "highly compensated employees" of current law, but rather those employees who, at any time during the three year period ending on the last day of the year in question, meet any one of the following descriptions: (1) owners of one percent or more of the employer (under appropriate attribution rules); (2) employees receiving at least $50,000 in annual compensation; (3) employees who were among the top ten percent of employees by compensation or who were among the highest three employees by compensation, but not if they received less than $20,000 in annual compensation; or (4) family members of a prohibited group member with respect to such year. It would be appropriate to provide for the automatic expansion or contraction of the ten percent and highest three classes in category (3) based on certain objective characteristics, such as the salary structure of an employer's workforce, and to contract the highest three class for very small employers. It may also be appropriate to adjust the three year lookback period where there has been a significant change in the size of an employer's workforce. Finally, the $50,000 and $20,000 dollar amounts would be indexed for inflation.

Second, the ADP test would be satisfied only if no prohibited group member had a deferral ratio in excess of the greater of the following two amounts: (1) 125 percent of the ADP for the non-prohibited group eligible employees, or (2) the lesser of 200 percent of the ADP for the other eligible employees or the ADP for the other eligible employees plus two percentage points. In calculating the deferral ratio for a prohibited group member, only the first $200,000 of compensation would be considered.

Third, if the deferral ratio for any prohibited group member for a year exceeded the applicable limit for such year, the excess elective contributions would be treated as nondeductible employer contributions subject to the ten percent tax on contributions in excess of the applicable deduction limits. Thus, excess elective contributions would not be deductible by the employer in the year paid and would be subject to an annual tax of ten percent for the year of contribution. See Ch. 14.03. Also, excess elective contributions (and any earnings attributable thereto) would have to be distributed by the end of the plan year following the plan year to which the contributions related. Such a required distribution would not be treated as violating the distribution restrictions applicable to elective contributions or to qualified plans generally. Also, a required distribution would be exempt from the early distribution recapture tax applicable to tax-favored plan. See Ch. 14.02. If excess elective contributions and related earnings are not distributed by the end of the applicable plan year, the CODA would cease to be qualified as of the plan year to which the excess contributions related.

A special nondiscriminatory eligibility test would be applied to CODAs. Under this test, the ratio of prohibited group members eligible to make elective contributions under the CODA to the total prohibited group members could not exceed 125 percent of the analogous ratio for the other employees. In applying this test, employees with less than one year of service, employees who have not attained age 21, employees covered by a collective bargaining agreement, and nonresident aliens with no U.S. earned income would be disregarded. See Ch. 14.09.

For purposes of applying the ADP test, CODAs covering a common prohibited group member would be treated as a single CODA.

A CODA would be precluded from requiring, as a condition of eligibility, employees to complete more than one year of service.

The CODA distribution restrictions would be modified to preclude distributions of amounts attributable to elective contributions before the employee's death, disability, or separation from service, or plan termination.

An employer would be prohibited from conditioning, either directly or indirectly, contributions and benefits (other than employer matching contributions) to employees' elective contributions under a CODA.

Finally, CODAs would be available only to taxable employers. Tax-exempt and public sector employers would be precluded from maintaining CODAs.

Employer Matching Contributions. Special nondiscrimination rules would be applied to employer matching contributions in lieu of the general nondiscrimination rules. Employer matching contributions that (1) are wholly nonforfeitable upon contribution, (2) may not be distributed from the plan prior to the employee's death, disability, or separation from service, or plan termination, and (3) are not in excess of 100 percent of the employees' mandatory contributions would be required to satisfy the ADP test as if such contributions were elective contributions. If the employer matching contributions were tied to elective contributions under a CODA, the matching contributions would be combined with the elective contributions for purposes of determining whether both the elective contributions and the matching contributions satisfied the ADP test.

If the employer matching contributions were (1) not wholly nonforfeitable upon contribution, (2) distributable before the employee's death, disability, or separation from service, or plan termination, or (3) in excess of 100 percent of the employees' mandatory contributions, the matching contributions would be required to satisfy the ADP test as though they were elective contributions. For this purpose, however, the deferral ratio for each prohibited group member would be limited to the greater of the following two amounts: (1) 110 percent of the ADP for the non-prohibited group members, or (2) the lesser of 150 percent of the ADP for the non-prohibited group members or the ADP for the non-prohibited group members plus one percentage point.

If employer matching contributions under a plan for any individual for a year were in excess of the applicable limit for such year, the excess matching contributions would be treated in the same fashion as excess elective contributions to a CODA. Thus, such excess matching contributions would not be deductible by the employer for the year of contribution and would be subject to a ten percent tax for the year of contribution. See Ch. 14.03. Also, excess matching contributions (and any earnings attributable thereto) would have to be distributed by the end of the plan year following the plan year to which the contributions related. This is the case without regard to whether the excess matching contributions were vested upon contribution. A required distribution of excess matching contributions and related earnings would not be treated as violating any applicable distribution restrictions. Also, such a required distribution would be exempt from the early distribution recapture tax applicable to tax-favored plans. See Ch. 14.02. If excess matching contributions and related earnings are not distributed by the required date, the plan will cease to be qualified as of the plan year to which the contributions related.

Effective Dates

The proposals relating to CODAs and employer matching contributions would apply to plan years beginning on or after January 1, 1986. For collectively bargained plans, the proposals would apply to plan years beginning after the termination of the collective bargaining agreement.

However, an employee's accrued benefit under a CODA as of the last day of the first plan year ending on or after December 31, 1985 would continue to be subject to the current law distribution limits on elective contributions.

Analysis

The following table illustrates the proposed modifications to the nondiscrimination rules for CODAs (i.e., fully vested and nondistributable elective contributions and employer matching contributions) and for other employer matching contributions. Note that the percentage limits set forth below under current law and under the proposals refer to the employees' compensation, and that the current law CODA limits apply to the average of the elective deferrals by the highly compensated employees, whereas the proposed limits apply to each prohibited group member's deferral ratio.

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Table 14.06-1

Current and Proposed Nondiscrimination Limits for CODAs and Other Employer Matching Contributions

(In Percent)

Base ADP for Non-Prohibited Group	Current Maximum CODA ADP for High-Paid Group	Proposed Maximum CODA Deferral Ratio for Each Prohibited Group Member	Proposed Maximum Non-CODA Matching Contribution for Each Prohibited Group Member
1	2.5	2.00	1.5
2	5.0	4.00	3.0
3	6.0	5.00	4.0
4	7.0	6.00	5.0
5	8.0	7.00	6.0
6	9.0	8.00	7.0
7	10.5	9.00	8.0
8	12.0	10.00	9.0
9	13.5	11.25	10.0
10	15.0	12.50	11.0
11	16.5	13.75	12.1
12	18.0	15.00	13.2

Office of the Secretary of the Treasury May 28, 1985

The proposals would reduce the currently excessive disparity permitted between the elective contributions of the prohibited group members and the elective contributions of the other employees. However, the proposals would still authorize some disparity, which is appropriate to permit prohibited group members near retirement to make larger contributions. Also, by more narrowly defining the "prohibited group," the proposals would generally enhance employee flexibility in CODAs.

As the table reflects, under the proposals, there would be a significant difference between the maximum elective and matching deferrals permitted under a CODA for prohibited group members and the maximum employer matching contributions that may be provided to prohibited group members without satisfying the vesting and distribution rules for CODAs. This difference in maximums is necessary to encourage employers to make employer matching contributions that comply with the CODA vesting and distribution requirements.

MODIFY RULES FOR BENEFIT FORFEITURES

General Explanation

Chapter 14.07

Current Law

Tax-favored treatment is provided with respect to funds set aside in employer-maintained plans that satisfy certain qualification requirements. Among these requirements is one providing that benefits under a money purchase pension plan that are forfeited upon the employee's separation from service for the employer maintaining the plan may not be used to increase the benefits any other employee would receive under the plan. The forfeited amounts must be used to reduce future employer contributions to the plan or to offset plan administrative expenses. Forfeited benefits under a profit-sharing or stock bonus plan may be reallocated to the remaining participants and thus may be used to increase the benefits that the participants would otherwise receive.

Reasons for Change

Uniform rules governing the treatment of forfeitures should be applied to all qualified plans. Also, because forfeitures are treated as contributions and other additions for purposes of the annual limits on contributions, permitting pension plans to reallocate forfeitures among plan participants generally will benefit rank-and-file employees, and not merely highly compensated employees.

Proposal

Qualified money purchase pension plans would be permitted to use benefits forfeited by a separated employee to increase the benefits that other employees would otherwise receive under the plan.

Effective Date

The proposal would apply to plan years ending on or after January 1, 1986.

Analysis

Under the proposal, a qualified money purchase pension plan could provide that forfeited benefits will be used to reduce future employer contributions or to offset administrative expenses, or that forfeitures will be reallocated among the remaining participants.

MODIFY LOAN RULES FOR TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.08

Current Law

Generally, if an employee or beneficiary in a qualified profit-sharing, pension, stock bonus, or annuity plan or a tax-sheltered annuity receives any amount as a loan, such amount is treated as having been received as a taxable distribution. An exception to this general rule provides that a loan shall not be treated as a taxable distribution to the extent that the loan (when added to the outstanding balance of all other loans from such plan) does not exceed the lesser of two amounts: (1) $50,000, or (2) the greater of $10,000 or one-half of the employee's accrued benefit under the plan. This exception is available, however, only for a loan that is required to be repaid within five years or, if the loan proceeds are used to acquire or improve the principal residence of the employee or a member of the employee's family, is required to be repaid within a reasonable time.

Reasons for Change

The rules governing the tax treatment of loans from certain tax-favored plans are aimed at limiting the extent to which an employee may currently use assets held by a plan for nonretirement purposes and at assuring that loans are actually repaid within a reasonable period. However, there is concern that the current rules do not prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance through the use of balloon repayment obligations and bridge loans from third-parties.

In addition, the current rule permitting home loans with repayment periods extending beyond five years for family members of the employee and for certain improvements on existing principal residences is overly broad and difficult to apply. The rule's breadth effectively eliminates the application of the five year limit in many situations for which a five-year rule is appropriate. The favorable tax treatment for amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and any exceptions to this general policy should be narrowly limited.

Proposals

The exception to the general rule for loans less than a specified amount would be modified so that the $50,000 limit is reduced by the highest outstanding loan balance owed by the employee to the plan during the prior twelve months. Thus, the exception as modified would provide that a loan would be treated as a taxable distribution only to the extent that the loan (when added to the outstanding balance of all other loans from the plan) does not exceed the lesser of the following two amounts: (1) $50,000, reduced by the highest outstanding loan balance owed by the employee to the plan during the prior twelve months, or (2) the greater of $10,000 or one-half of the employee's accrued benefit under the plan.

The special rule for home loans would be available only for the first-time purchase of a principal residence by and for the employee. Plan loans to improve an existing principal residence, to purchase a second home, and to finance the purchase of a home or home improvements for other members of the employee's family would be subject to the five year repayment rule.

Effective Date

The modifications to the rules governing the tax treatment of loans from certain tax-favored plans would apply with respect to all amounts received as a loan on or after January 1, 1986. Loans outstanding on January 1, 1986 that are renegotiated, extended, renewed, or revised on or after that date generally would be treated as loans made on the date of modification.

Analysis

Under the proposed limit on plan loans, an employee who borrowed $50,000 from a qualified plan on January 1, 1986, and repaid the full principal, with interest, on December 31, 1990, would be precluded from borrowing additional amounts from the plan on a nontaxable basis until 1992. Thus, employees would generally not be able to maintain permanent $50,000 outstanding loans from plans through the use of balloon payments and short-term bridge loans.

Most employees, however, repay plan loans on a regular basis, often by payroll deduction. These employees generally would not be affected by the proposed modification. For example, assume an employee borrows $50,000 from a qualified plan on January 1, 1986, and commits to repaying the principal in equal monthly installments over a five-year period ($833.33 per month, plus interest). During the first year of repayment, the employee would not be able to make a second, nontaxable loan. However, at the end of the second year, $10,000 would be available for loan on a nontaxable basis. At the end of the fifth year of repayment, $40,000 would be available. And in 1992, the full $50,000 would again be available as a nontaxable loan.

MODIFY NONDISCRIMINATORY COVERAGE TEST FOR TAX-FAVORED RETIREMENT PLANS

General Explanation

Chapter 14.09

Current Law

A profit-sharing, stock bonus, pension, or annuity plan must be nondiscriminatory in coverage in order to qualify for favorable treatment. More specifically, such qualified plans must provide benefits to a group meeting one of the following descriptions: (1) at least 70 percent of all the nonexcludable employees who have satisfied the maximum age and service conditions; (2) at least 80 percent of all eligible employees, but only if at least 70 percent of the nonexcludable employees who have satisfied the maximum age and service conditions are eligible; or (3) a classification of nonexcludable employees that is not discriminatory in favor of employees who are officers, shareholders, or highly compensated. For purposes of this rule, excludable employees are those employees who are covered by a collective bargaining agreement and nonresident aliens without U.S. earned income. The maximum service condition for a plan is one year of service for the employer (or, if employees are fully vested on employer-derived benefits immediately upon accrual, three years of service), and the maximum age condition is age 21.

Neither the Congress nor the Internal Revenue Service has attempted to define in a detailed way the classes of individuals--i.e., officers, shareholders, and highly compensated employees--in whose favor discrimination is prohibited (the "prohibited group"). Moreover, no objective standards have been established for determining whether coverage is based on a nondiscriminatory classification. Instead, these issues, i.e., whether an employee is a shareholder, an officer, or highly compensated, and whether any particular classification of covered employees is nondiscriminatory, have been left for resolution on the basis of the facts and circumstances in each particular case.

The existing facts and circumstances approach to the classification test requires that the class of covered employees be nondiscriminatory both on its face and in actual operation. In determining whether a classification discriminates in operation, there may be a "reasonable difference" between (1) the ratio of the prohibited group members covered under a plan to the total prohibited group members employed by the employer and (2) the ratio of the other employees covered under the plan to the total non-prohibited group employees of the employer. The comparison of these ratios, however, is only one of the factors to be considered in testing whether a classification is nondiscriminatory.

Reasons for Change

The basic rationale for the tax-favored treatment afforded qualified plans is that such plans, in providing for the retirement security of individual employees or groups of employees, contribute to the national goal of providing security for all retired workers. Thus, tax incentives for qualified plans harness the initiative and energy of the private sector to meet responsibilities that might otherwise fall upon government and government-funded programs. If this use of the tax system is to be justified, however, coverage under qualified plans must be made available on the broadest possible basis. Absent such broad coverage, qualified plans are less an instrument of national retirement policy than a form of tax-preferred investment for a limited class of taxpayers.

The nondiscriminatory coverage test of current law fails adequately to assure that the tax advantages of qualified plans are available only where coverage is provided on a broad, nondiscriminatory basis. Under the current facts and circumstances approach, employers are left with substantial uncertainty concerning whether their plans qualify. As a consequence, some employers will apply relatively strict standards to ensure qualification. Others, however, take the lack of certainty as permitting an agressive approach to coverage issues. The result is a patchwork of employee coverage patterns, ranging from plans that cover a broad cross-section of employees at all income levels to plans that focus benefits on the highly compensated. Such inconsistent coverage is unfair to individual employees and fails to condition tax-favored treatment on broad, nondiscriminatory coverage.

In order that qualified plan coverage be provided on the broadest possible basis, it is important not only that nondiscrimination tests provide greater certainty, but also that such tests prevent coverage that disproportionately favors the highly compensated. Current administrative rulings have made possible arguments that, for example, a plan may satisfy the nondiscriminatory classification test so long as a high percentage of an employer's employees is in the middle- and lower-income groups and a meaningful percentage (e.g., 40 percent) of these employee groups is covered, even though the plan may cover 100 percent of the employer's prohibited group members. To prevent discriminatory coverage, it is appropriate that the coverage ratios for prohibited and for non-prohibited group members not vary by a substantial margin. Such requirement, if combined with a procedure for case by case review of plans presenting special circumstances, would ensure that tax-favored treatment be limited to plans that serve the national policy of providing retirement security on a broad, nondiscriminatory basis.

Proposals

A profit-sharing, stock bonus, pension, or annuity plan would be required to satisfy a nondiscriminatory coverage test as a condition of tax qualification. Under this test, the percentage of the employer's prohibited group members benefiting under the plan would not be permitted to exceed 125 percent of the percentage of the employer's other employees benefiting under the plan. Employees in a class of excludable employees would be disregarded in applying this 125 percent test if the plan does not benefit any employee in such class.

An employee would be treated as a prohibited group member with respect to a plan year if, at any time during the three year period ending on the last day of the plan year, the employee met any one of the following descriptions: (1) an owner of one percent or more of the employer (under appropriate attribution rules); (2) an employee receiving at least $50,000 in annual compensation; (3) an employee who is among the top ten percent of employees by compensation or who is among the highest three employees by compensation, but not if he or she received less than $20,000 in annual compensation; or (4) a family member of another prohibited group member with respect to such year. It would be appropriate to provide for the automatic expansion or contraction of the ten percent and highest three classes in category (3) based on certain objective characteristics, such as the salary structure of an employer's workforce, and to contract the highest three class for very small employers. It may also be appropriate to adjust the three year lookback period where there has been a significant change in the size of an employer's workforce. Finally, the $50,000 and $20,000 dollar amounts would be indexed for inflation.

In applying the 125 percent coverage test, the following classes of employees would be treated as excludable: (1) employees with less than one year of service (or, if benefits are vested immediately on accrual and the plan does not contain a cash or deferred arrangement (see Ch. 14.06), two years of service); (2) employees who have not attained age 21; (3) employees covered by a collective bargaining agreement; and (4) nonresident aliens with no U.S. earned income.

In very limited situations where compelling business reasons indicate that application of the 125 percent test would not be appropriate (e.g., for a limited period following a merger or acquisition of businesses), an employer would be permitted to obtain a timely ruling from the Internal Revenue Service that the employer's plan satisfies the nondiscriminatory coverage test even though it fails to satisfy the 125 percent test. The Internal Revenue Service would be permitted to apply any reasonable conditions on the continued validity of such a ruling.

In addition, any classification of employees used by a plan for participation purposes would be required to be nondiscriminatory on its face. For example, except to the extent permitted under the rules permitting integration with social security, it would be impermissible for a plan to provide that only employees earning more than $45,000 in compensation will be covered, even if the plan otherwise satisfies the 125 percent coverage test. A plan requiring an employee contribution as a condition of participation or excluding employees in a bona fide job category from participation would generally not be deemed to be discriminatory on its face.

For purposes of applying this nondiscriminatory coverage test, plans covering a common prohibited group member would be treated as a single plan.

Effective Date

The proposed nondiscriminatory coverage test would apply to plan years beginning on or after January 1, 1987. For collectively bargained plans, the test would not apply to plan years beginning before the termination of the collective bargaining agreement.

Analysis

The proposed 125 percent coverage test would assure that a plan claiming favorable tax treatment actually provides benefits to a nondiscriminatory classification of employees. The test would require some qualified plans to provide benefits to additional numbers of non-prohibited group employees. Without changes to the plans' benefit formulas, this would tend to increase the costs of these plans. However, because these increased costs would be attributable to expanded plan coverage, the costs would be justified as furthering the fundamental objective of providing benefits to broad cross-sections of employees on a nondiscriminatory basis. In addition, a plan could offset any resulting increased costs by reducing the benefits provided to all employees for future years of service or by reducing the coverage of prohibited group members.

Application of the 125 percent coverage test is illustrated by the following example. Assume that an employer has 100 nonexcludable employees, 20 of whom are prohibited group members with respect to a plan year. Assume further that 60 of the 80 non-prohibited group employees are covered under the plan (i.e., 75 percent), and that 12 of the covered non-prohibited group employees do not actually receive benefits under the plan because the plan is properly integrated with social security. Under the proposed test, the percentage of the 20 prohibited group members who benefit under the plan would not be permitted to exceed 125 percent of the percentage of the non-prohibited group employees who benefit under the plan; sixty non-prohibited group employees benefit under the plan for this purpose. Thus, if more than 18 of the prohibited group members (1.25 x (60/80) x 20, or 18.75) benefitted under the plan, it would not satisfy the test.

The 125 percent test would not be an appropriate test in certain limited situations. For example, assume that an employer maintaining a qualified plan acquires another company during a plan year and the acquired company did not maintain a qualified plan for its employees. It thus may be appropriate to treat the acquiring company's qualified plan, if it satisfied the 125 percent test before the acquisition, as satisfying the nondiscriminatory coverage test for a limited period after the acquisition to permit the post-acquisition employer to redesign the qualified plan or to establish a new plan to satisfy the

125 percent test. Of course, during the limited period, the acquiring company's plan would be required to satisfy any reasonable conditions that the Internal Revenue Service may impose as part of the timely ruling, such as that the plan satisfy the nondiscriminatory coverage test by reference to the entire post-acquisition company with a more liberal percentage (e.g., 150 percent) substituted for 125 percent.

Finally, consideration would be given to adoption of a rule precluding the exclusion of employees or any group of employees in the absence of a bona fide business purpose, in order to prevent an employer from excluding, by design, the maximum number of non-prohibited group members that can be excluded without failing the 125 percent test.

UNIFY RULES FOR UNFUNDED DEFERRED COMPENSATION ARRANGEMENTS OF STATES AND TAX-EXEMPT EMPLOYERS

General Explanation

Chapter 14.10

Current Law

In general, employees are subject to tax not only on compensation actually received but also on amounts the receipt of which is, at the employee's election, deferred until a later year. The application of this general rule of constructive receipt to nonqualified and unfunded deferred compensation arrangements is modified for amounts deferred under either a "private deferred compensation plan" or an "eligible State deferred compensation plan." Neither of these plans is available to tax-exempt employers.

A "private deferred compensation plan" is a plan or arrangement maintained by a taxable employer under which the receipt of cash compensation is deferred, at an employee's election, on an unfunded basis. The taxable year of inclusion under these plans is to be determined in accordance with the applicable rules and judicial decisions in effect on February 1, 1978.

Under an "eligible State deferred compensation plan," an employee of a State who elects to defer the receipt of current compensation will be taxable on the deferred amounts (and on any income attributable thereto) when such amounts are paid or otherwise made available. In order to qualify as an eligible State plan, deferred amounts must remain, at all times until subsequently paid or made available, solely the property of the State, subject only to the claims of the State's general creditors. The maximum annual deferral under an eligible State plan is the lesser of (1) $7,500 or (2) 33-1/3 percent of the employee's compensation. The rules provide a special catch-up limit permitting higher deferrals for the three years immediately preceding an employee's normal retirement age. Amounts deferred by employees under tax-sheltered annuities are taken into account in applying these limits.

Amounts deferred by an employee under an eligible State plan may be automatically transferred to the eligible plan of another employer in which the employee becomes a participant if (1) the entities sponsoring the plans are located within the same State, (2) the transferee plan provides for the acceptance of the amounts, and (3) the transferor plan provides that if an employee separates from service in order to accept employment with another such entity, deferred amounts will be automatically transferred.

A deferral under an eligible State plan may not be made available to an employee before separation from service with the State or an unforeseeable emergency. In addition, distributions of amounts under an eligible plan must commence within 60 days after the later of two dates: (1) the close of the year in which the employee or former employee attains the normal retirement age, or (2) the close of the plan year in which the employee separates from service for the State. Distributions over the employee's lifetime must be projected to exceed 50 percent of the total benefits payable with respect to the employee and any beneficiaries. Finally, if the employee dies before his or her entire benefit is distributed, the remaining portion of the benefit must be distributed to the employee's beneficiary over (1) the life of the beneficiary (or shorter period), if the beneficiary is the employee's surviving spouse, or (2) a period not in excess of fifteen years.

If an unfunded State plan does not qualify as an eligible plan, a deferral is included in the employee's gross income when there is no longer a substantial risk of forfeiture of such amount (e.g., the employee's right to the deferred amount is no longer conditioned upon the future performance of substantial services).

Reasons for Change

Employees of tax-exempt employers should have access to nonqualified, unfunded deferred compensation arrangements on essentially the same basis as other employees. Current law denies such equal access by applying constructive receipt principles to employees of tax-exempt entities, while permitting deferral of tax for State employees and employees of taxable employers until actual receipt. As a consequence, employees of tax-exempt employers are at a relative disadvantage in providing for their retirement income security. Moreover, under current law, some employees of tax-exempt employers are deferring compensation on a nonqualified and unfunded basis without regard to either the general constructive receipt rule or the rules governing eligible plans. Application of specifically defined rules would ensure that employees of tax-exempt employers who do defer compensation on a nonqualified, unfunded basis receive comparable tax treatment.

Although employees of tax-exempt employers should have comparable access to nonqualified, unfunded deferred compensation arrangements, there are practical constraints on the use of such arrangements by taxable employers that would not similarly affect tax-exempt employers. A taxable employer's deduction for deferred amounts in a nonqualified arrangement is postponed until the employee includes the amounts in income. There is thus a tension between the tax treatment of a taxable employer and that of an employee which limits the amount of compensation the employer will permit an employee to defer. However, as is the case with States, tax-exempt employers are indifferent about the timing of the tax deduction for deferred compensation. Thus, in order that nonqualified, unfunded deferred compensation arrangements be available to all employees on roughly the same basis, it is appropriate to limit the amount of deferral for employees of tax-exempt employers as well as for public sector employees.

In addition, nonqualified and unfunded deferred compensation plans should not enable employees to defer the receipt of income indefinitely or to transfer deferred amounts to subsequent generations. Thus, certain modifications to the existing distribution rules applicable to eligible State plans should be made to assure that the employee, rather than the employee's beneficiaries, will receive a substantial portion of the deferred benefits over the employee's lifetime. Finally, certain of the existing restrictions on deferred compensation arrangements impose burdens that do not further the retirement security of employees.

Thus, the existing rules prohibit an employee from electing to receive deferred amounts before separation from service or an unforeseeable emergency even though the employee has decided to cease participation in the eligible plan and the deferred amounts are de minimis. In addition, the existing restrictions on transfers between eligible plans have the practical effect of forcing employees to receive their deferred amounts even though they are participating in an eligible plan maintained by another State.

Proposals

The rules permitting the elective deferral of compensation by employees of States on a nonqualified and unfunded basis would be expanded to apply to the employees of employers exempt from tax under the Internal Revenue Code. Thus, an employee of a tax-exempt employer would be permitted to defer, on an elective basis and subject to the same limitations currently applicable to State employees, a portion of his or her current compensation under a nonqualified and unfunded arrangement maintained by the employer (an "eligible deferred compensation plan"). Compensation deferred by an employee of a State or a tax-exempt employer under an ineligible deferred compensation plan would be includable in the employee's gross income when there is no longer a substantial risk of forfeiture.

The expanded rules governing eligible deferred compensation plans generally would be consistent with the current rules applicable to States. However, certain modifications would be made to these rules in expanding them to cover both categories of employees.

The required distribution rules for benefits under eligible deferred compensation plans would be modified to require that (1) the benefits projected to be payable over the lifetime of the employee exceed 66-2/3 percent of the total benefits projected to be payable with respect to the employee; (2) if payments are to be made over a period extending beyond one year, payments be made on at least an annual and substantially nonincreasing basis; and (3) distributions of benefits to a beneficiary of an employee commence within one year following the employee's death.

A deferred compensation arrangement would not fail to be an eligible deferred compensation plan and amounts would not be treated as made available to an employee merely because, under the arrangement, an employee may at any time elect to receive, in a single sum within 60 days of the election, all amounts deferred for his or her benefit. However, this rule would apply with respect to an employee only if such employee's total deferred benefit is not in excess of $3,500 and the employee is no longer eligible to defer compensation with respect to the State or tax-exempt employer.

Finally, the applicable rules would be modified to permit the automatic transfer of deferred amounts between any two eligible plans, whether or not maintained within the same State, only if the following are satisfied with respect to both the transferor and transferee plans: (1) the plans provide for the acceptance of such automatic transfers with respect to all individuals who become employees of the employers maintaining the plans; and (2) the plans provide for the automatic transfer of deferred amounts with respect to all employees who separate from service and become employed for employers maintaining eligible plans that accept such transfers. Transfers not conforming to these conditions would be prohibited.

Effective Date

The application of the rules governing eligible State plans to the nonqualified and unfunded deferred compensation arrangements of tax-exempt employers, and the modifications to these rules for both States and tax-exempt employers, would apply to taxable years of individuals beginning on or after January 1, 1986.

Analysis

The expansion to tax-exempt employers of nonqualified, unfunded deferred compensation arrangements will permit their employees to provide for retirement security on the same basis as other employees, and would ensure uniform treatment of those employees of tax-exempt employers that may now be deferring compensation, without regard to constructive receipt principles or to the limits applicable to eligible State plans. The proposal would not, however, affect the treatment of a nonqualified deferred compensation plan under the labor provisions of the Employees Retirement Income Security Act of 1974.

The modifications to the rules currently applicable to eligible State plans are designed to target the permitted arrangements more specifically at retirement savings. Thus, the minimum distribution modifications would limit the ability of employees to defer benefits beyond retirement. Also, the modification to permit automatic benefit transfers between eligible plans in different States would enhance the portability of these deferred amounts and thus the likelihood that they will be received as retirement income.